Preparing for an unwanted trajectory

Potential impact on U.S. pension funded status of 10-Year Treasury yields going to 0%

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AS NOTED RECENTLY BY GFICC CIO BOB MICHELE,[1] WHILE WE HOPE THAT 10-YEAR U.S. TREASURY YIELDS DO NOT REACH 0%, THAT SEEMS TO BE THE TRAJECTORY WE ARE ON. We wanted to illustrate the potential range of impacts on the funded status of corporate pension plans if this were to occur.

Since it's difficult to predict with a high degree of certainty how various asset classes would perform under such a drastic decrease in Treasury yields, below are the results of a simplified analysis meant to illustrate a few main points. With the 10-year yield around 2% as of July 31, 2019, we've assumed that discount rates across the curve fall by 200bps (this would imply negative Treasury yields at some maturities but the likelihood and implications of this are beyond the scope and context of this discussion). We've also assumed an initial funded status of 88%, which is our estimate for an average pension plan as of July 31.

IMPACT OF 200BPS DROP IN DISCOUNT RATES

Hedge/growth allocation	Growth portfolio return								
	-20%	-15%	-10%	-5%	–	5%	10%	15%	20%
30%/70%	-21.2%	-18.7%	-16.2%	-13.7%	-11.2%	-8.7%	-6.3%	-3.8%	-1.3%
40%/60%	-17.8%	-15.7%	-13.5%	-11.4%	-9.3%	-7.2%	-5.0%	-2.9%	-0.8%
50%/50%	-14.5%	-12.7%	-10.9%	-9.1%	-7.4%	-5.6%	-3.8%	-2.0%	-0.3%
60%/40%	-11.1%	-9.7%	-8.3%	-6.8%	-5.4%	-4.0%	-2.6%	-1.2%	0.3%
70%/30%	-7.7%	-6.7%	-5.6%	-4.5%	-3.5%	-2.4%	-1.4%	-0.3%	0.8%
80%/20%	-4.4%	-3.7%	-3.0%	-2.3%	-1.5%	-0.8%	-0.1%	0.6%	1.3%

FUNDED STATUS FOLLOWING 200BPS DROP IN DISCOUNT RATES (FROM 88%)

Hedge/growth allocation	Growth portfolio return								
	-20%	-15%	-10%	-5%	–	5%	10%	15%	20%
30%/70%	66.8%	69.3%	71.8%	74.3%	76.8%	79.3%	81.7%	84.2%	86.7%
40%/60%	70.2%	72.3%	74.5%	76.6%	78.7%	80.8%	83.0%	85.1%	87.2%
50%/50%	73.5%	75.3%	77.1%	78.9%	80.6%	82.4%	84.2%	86.0%	87.7%
60%/40%	76.9%	78.3%	79.7%	81.2%	82.6%	84.0%	85.4%	86.8%	88.3%
70%/30%	80.3%	81.3%	82.4%	83.5%	84.5%	85.6%	86.6%	87.7%	88.8%
80%/20%	83.6%	84.3%	85.0%	85.7%	86.5%	87.2%	87.9%	88.6%	89.3%

For an average plan with a funded status of 88% and 50% invested in fixed income having a dollar duration similar to their liability, over 20% returns from the growth portfolio would be required to maintain a constant funded status. Funded status would decrease by over 7% if the growth portfolio did not change and would decrease by even more if the growth portfolio experienced

[1] "10 Year US Treasury Yields Are Headed to 0%?", Bob Michele, Global Fixed Income blog, J.P. Morgan Asset Management; https://blog.jpmorganinstitutional.com/2019/07/10-year-us-treasury-yields-are-headed-to-0/

negative returns. Negative growth portfolio returns are a realistic possibility if Treasury yields were to drop by such a significant amount, likely reflecting economic growth concerns.

It should be no surprise that plans which are better hedged to changes in interest rates will perform better in these scenarios. For a 10% drop in growth assets, a plan with an 80% fixed income allocation would experience a 3% decrease in funded status, while a plan with 30% in fixed income would lose over 16% in funded status.

While not many people would consider a 0% yield on 10-year Treasuries a likely outcome, not many people predicted that the yield would fall by nearly 150bps through August 13, 2019, from 3.16% as of October 31, 2018. In fact, at any given point in time, the forward curves and many people typically expect yields to rise in the future. This is one of the reasons often given for delaying pension de-risking. The YTD yield moves reinforce the difficulty of timing the market and that it is usually best to implement strategic de-risking decisions without interference from short-term market views.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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